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**CITY OF NAPA  
MEMORANDUM ON INTERNAL CONTROL  
AND  
REQUIRED COMMUNICATIONS**

**FOR THE YEAR ENDED  
JUNE 30, 2009**

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**CITY OF NAPA  
MEMORANDUM ON INTERNAL CONTROL  
AND REQUIRED COMMUNICATIONS**

**For the Year Ended June 30, 2009**

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## **MEMORANDUM ON INTERNAL CONTROL STRUCTURE**

March 15, 2010

To the City Council of the  
City of Napa, California

In planning and performing our audit of the financial statements of the City of Napa as of and for the year ended June 30, 2009, in accordance with auditing standards generally accepted in the United States of America, we considered the City's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control. Accordingly, we do not express an opinion on the effectiveness of the City's internal control.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

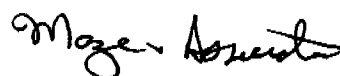
A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control was for the limited purpose described in the first paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We noted no matters that we consider to be material weaknesses, however, we noted other deficiencies in internal control that we consider to be significant deficiencies that are included on the Schedule of Significant Deficiencies.

Included in the Schedule of Other Matters are recommendations not meeting the above definitions that we believe to be of potential benefit to the City.

The City's written responses included in this report have not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on them.

This communication is intended solely for the information and use of management, City Council, others within the organization, and agencies and pass-through entities requiring compliance with generally accepted government auditing standards, and is not intended to be and should not be used by anyone other than these specified parties.



## CITY OF NAPA

### MEMORANDUM ON INTERNAL CONTROL SCHEDULE OF SIGNIFICANT DEFICIENCIES

#### 2009-01 Timeliness of the Close of the Books

We noted in the prior three years' Memorandums on Internal Control that a shortage of experienced accounting staff caused difficulty and delays in the timely completion of the close of the City's books. Conditions during the year end audit work conducted after June, 30 2009 were exacerbated by the financial system implementation, the absence of the Finance Director from the closing process who had been assigned to oversee that system implementation and the departure of the Finance Manager. The system implementation was given top priority during the first six months of the fiscal 2009-2010. Because of these issues, management hired an Interim Finance Director and assigned an existing Finance Department consultant to act as Interim Finance Manager to ensure adequate skills were in place to keep the Department functioning. In total, the City is using four consultants to shore up its finance staff on a temporary basis to maintain processes and procedures.

During our audit, we performed sufficient tests to satisfy ourselves that processes and procedures were in place to produce accurate financial data for inclusion in the financial statements and we satisfied ourselves that there were no material errors in the financial statements. We noted post closing adjustments decreased to 18 from the 23 which occurred in the prior year and once data was received from staff, it was in generally accurate and reliable. Our work was delayed a number of times due to competing demands on staff which was unable to provide us with certain data required for the audit until March 2010. These delays are compounded by the need of the Housing Authority to file its financial data online by March 31 which is also the Single Audit filing deadline.

The City has made substantial progress in the system implementation and the effects felt this year are not expected to be a major problem in future years. However, the Finance Department in its current state cannot adequately function without either the continuation of the consultants or permanent replacements. We understand that all of the consultants' contracts end in June 2010.

The City should address its staffing needs as soon as possible to ensure resources are available as needed for operations and to provide continuity during the next fiscal close which will be the first close on the new system. In addition, continued refinement of the system should be ongoing to ensure that the timeliness of critical closing procedures improves to ensure required reporting can be completed in a timely fashion.

#### *Management Response:*

Management is aware that the reliance on temporary consultants is not a long-term solution to the current staffing needs, and intends to fill all permanent staff vacancies by December 2010 (current consulting contracts will be extended past June 30 as required.) It is anticipated that additional consultants currently assisting on a temporary basis will be let go once all elements of the transition to the new system have been sufficiently addressed.

The delay in the fiscal 2009-10 close and related audit was the result of a conscious decision by the Finance Department management, with specific approval from the City Manager, to redirect the department's focus to the new system implementation and related reporting needs. Thus, the adjusted schedule enabled the department to work through issues on the new system before turning full attention to the completion of the 2009-10 work papers, which, as noted, were generally accurate and reliable.

CITY OF NAPA

MEMORANDUM ON INTERNAL CONTROL  
SCHEDULE OF SIGNIFICANT DEFICIENCIES

2008-01      Staffing Resources - Update

We noted in the prior two years Memorandums on Internal Control that a shortage of experienced accounting staff caused difficulty and delays in the timely completion of the close.

For fiscal 2007-08, we met with staff prior to the commencement of the audit to coordinate efforts and noted then and throughout our work that staff accepted more responsibility and ownership of data than in prior years and we noted an improvement in issue identification which serves to reduce risk of error. From a post closing adjustment perspective the number of entries proposed by staff was 23 for fiscal 2007-08, three less than the 26 proposed by staff in 2006-07. While this is not an excessive number of entries, we believe most of the adjustments can be incorporated in the close if there is better overview of data prior to commencement of the audit. In the best Finance Departments there is a strong overview function that identifies adjustments and corrects them prior to audit commence. The current system makes such an overview complicated and inefficient. Staff is aware of the issue and is working on implementing the new system (See our prior year comment 2007-05: Financial System Improvements). Many of our other clients use this same software and it has better reporting capabilities which would improve the overview function.

The Finance Manager function provides essential controls that are needed to maintain reduced risk of errors occurring and going undetected. We are aware that he is overseeing the implementation of the new system. His absence in the routine accounting function will need to be addressed. We recommend continued training of staff's understanding of generally accepted accounting principles theory and application. Also, alternative overview resources are needed if the Finance Manager is unable to complete such tasks.

As far as general ledger journal entry controls, we noted one entry which was reviewed by the Revenue Supervisor, but not the Accounting Manager and two entries did not document the person who posted the entry.

Continued efforts should be made to strengthen staff accounting theory and closing procedures.

*Current Status:*

The absence of the Finance Manager was addressed by backfilling the position with a consultant, who took over full responsibilities in July of 2009 as the Interim Finance Manager. The Finance Department management has continued its work to improve staff's understanding of generally accepted accounting principles theory and application. As noted in **2009-01**, post-closing adjustments decreased again in 2008-09 from the prior year. Further, new procedures were implemented in fiscal 2009-10 in conjunction with the new accounting system that will enable better control of journal entries and other entry of data. The new system also offers better reporting capabilities which has improved the department staff's ability to review and understand their areas of responsibility.

See additional information in item **2009-01 Timeliness of the Close of Books**.

## CITY OF NAPA

### MEMORANDUM ON INTERNAL CONTROL CURRENT STATUS OF PRIOR YEAR OTHER MATTERS

#### **2008-02 Information Technology Best Practices**

We conducted an Information Systems Review with our audit which encompassed the financial information system and the network environment that houses it. We significantly expanded our work from previous years beyond looking solely at financial information systems as a result of greater risks of unauthorized access caused by overall industry growth of web-based commerce and internet based financial systems. Internal controls that are present in the overall network environment have become more important and relevant to understanding the internal controls over financial systems. We believe Information System controls must be continuously improved and enhanced to stay ahead of the ever increasing sophistication of hackers and criminals.

Currently, there are no Information Technology standards which local governments are required to conform to. Indeed there are a wide variety of informal guidelines and suggested controls from many different organizations which local governments may use to implement appropriate controls to ensure adequate security over information technology. Our Information Technology staff have reviewed these informal guidelines and concluded that the certification and accreditation framework developed by the National Institute of Standards and Technology (NIST) for the Federal Information Security Management Act (FISMA) are the most appropriate for local government. NIST and FISMA represent the minimum security requirements for federal government agencies information systems. We understand the U.S. Department of Justice recommends these for local governments. Our procedures included performing an external network scan based on NIST criteria and in determining that internal control provides for:

- Internet access defenses including hacker prevention, detection and deterrent systems
- Security of data from physical or network access
- Adequately protecting data from unauthorized internal access
- Reasonable measures to ensure continuation of service

A summary of our results and "best practices" recommendations are as follows:

- *External Scan Results:* We performed an external scan based on PCIE standards (See below) and found potentially exploitable vulnerabilities in the City's externally facing systems (systems connected directly to the Internet) which may be used to gain control of those systems. Externally facing systems should have the greatest level of security. While these vulnerabilities were not deemed critical, they should be mitigated as soon as possible. In addition, the City should establish a means to monitor the effectiveness of their information systems control procedures, including periodic vulnerability scans. If the vulnerabilities cannot be patched other mitigating controls such as host based firewalls can be used.
- *Internal Scan Results:* Because of these external vulnerabilities, we performed a secondary scan of internal financial systems to determine if there were vulnerabilities to the financial systems. Our internal scan found exploitable vulnerabilities in the City's financial application server and one randomly selected workstation which potentially could permit unauthorized access to data. While these vulnerabilities were not deemed critical they should be mitigated as soon as possible. In addition, the City should establish a means to monitor the effectiveness of their information systems control procedures, including periodic vulnerability scans. If the vulnerabilities cannot be patched other mitigating controls such as host based firewalls can be used.



## CITY OF NAPA

### MEMORANDUM ON INTERNAL CONTROL CURRENT STATUS OF PRIOR YEAR OTHER MATTERS

- *Payment Card Industry Compliance* - Any organization that processes credit cards is required to comply with the Payment Card Industry Data Security Standard (PCI-DSS), even if the processing is outsourced. The standard was developed to minimize the risk of loss due to security breaches in processing credit card transactions. Merchants which conform to the Standard pay lower transaction fees than those that do not comply and they minimize their liabilities which may result from security breaches. The Standard requires varying levels of controls depending on transaction levels. In general, merchants must:
  1. Fill out a self-assessment questionnaire (SAQ).
  2. Submit the SAQ to acquiring banks.
  3. Perform quarterly external network scans and submit the results to acquiring banks.
  4. Have a full independent PCI audit performed by a Qualified Security Assessor (QSA) and submit it to acquiring banks. (Required for level 1 merchants only).

We believe the City qualifies as a Level 3 or 4 merchant due to activity levels of less than 1 million transactions and currently it need only complete and maintain the SAQ in-house. However, we understand SAQ submissions will become mandatory for Level 3 and 4 merchants within the near future. Staff have not completed the SAQ, but should do so and prepare for the submission requirement.

- *General Information Systems Controls* - We compared the City's information systems controls with the various NIST standards and believe improvements should be considered for implementation such as formalizing business continuity plans including alternate processing site locations, contingency planning and training. We provided a detailed report to the City Auditor and the City's Administrative Services staff which describes the relevant standards and the control status for their consideration.

As noted above, the City is not required to conform to NIST standards and could use another set of guidelines to ensure the adequacy of controls. However, we recommend the City select an appropriate industry standard such as NIST to plan, organize and monitor information security proactively.

- *Audit/Event Logging* - . We believe this is one of the more important standards of NIST. The City does not appear to have audit logs documenting any change, addition or deletion of user accounts within the financial information system. The City should have audit/event logs of any addition, deletion or change in financial information system user accounts and the logs should be monitored by someone without the rights to effect such changes to ensure only authorized appropriate changes are made. In addition, any administrative access such as upgrades or application modifications by Information Technology personnel, outside consultants or vendors should also be logged and reviewed.

#### *Current Status:*

The City implemented new accounting software on 7/1/2009 with the intention of adhering to the Information Technology Best Practices described above.

## CITY OF NAPA

### MEMORANDUM ON INTERNAL CONTROL CURRENT STATUS OF PRIOR YEAR OTHER MATTERS

#### **2008-03 Documentation of Bank Reconciliation Preparation and Reviews**

The January 2008 bank reconciliation did not contain documentation of who prepared it not who reviewed it. Such documentation is important to ensure accountability that each function has been completed.

#### *Current Status:*

This recommendation has been implemented.

#### **2008-04 GASB Statement No. 51, Accounting and Financial Reporting for Intangible Assets (Effective for fiscal 09/10) - Retroactive Application Required**

Governments have different types of intangible assets, such as easements, water rights, patents, trademarks, and computer software. Easements are referred to in the GASB 34 description of capital assets, which has raised questions about whether and when intangible assets should be considered capital assets for financial reporting purposes.

The absence of specific authoritative guidance has resulted in inconsistencies in the recognition, initial measurement, and amortization of intangible assets among governments. The objective of this Statement is to establish accounting and financial reporting requirements for intangible assets to reduce inconsistencies and enhance comparability.

#### A summary of the statement:

- Intangible assets should be classified, accounted for and reported as capital assets, unless excluded from the scope. Guidance in this statement is in addition to existing capital asset guidance. a
- GASB 51 specifically addresses the nature of intangible assets.
  - *Lack of physical substance.* An asset may be contained in or on an item with physical substance, for example, a compact disc in the case of computer software. An asset also may be closely associated with another item that has physical substance, for example, the underlying land in the case of a right-of-way easement. These modes of containment and associated items should not be considered when determining whether or not an asset lacks physical substance.
  - *Nonfinancial nature.* In the context of this Statement, an asset with a nonfinancial nature is one that is not in a monetary form similar to cash and investment securities, and it represents neither a claim or right to assets in a monetary form similar to receivables, nor a prepayment for goods or services.
  - *Initial useful life greater than one year.*

## CITY OF NAPA

### MEMORANDUM ON INTERNAL CONTROL CURRENT STATUS OF PRIOR YEAR OTHER MATTERS

- GASB 51 excludes:
  - Assets acquired or created primarily for the purpose of directly obtaining income or profit.
  - Assets resulting from capital lease transactions reported by lessees.
  - Goodwill created through the combination of a government and another entity.
- Recognition of an intangible asset occurs only if it is considered identifiable. That is when either of the following apply:
  - The asset is separable from the government. That is it can be sold, transferred, licensed, rented, or exchanged.
  - The asset arises from contractual or other legal rights, regardless of whether transferable or separable.
- Specific conditions must be present to recognize internally generated intangibles. Capitalization of costs begins after all of the following criteria are met:
  - Determination of specific objectives of the project and the nature of the service capacity expected upon the completion.
  - Demonstration of the feasibility that the completed project will provide its expected service capacity
  - Demonstration of the current intention, ability, and effort to complete or continue development of the intangible asset.
  - Internally generated computer software is used as an example in applying the specific conditions approach.
- Amortization lives are addressed:
  - Limited by contractual or legal provisions.
    - Renewal periods for rights may be considered if there is evidence that the government will seek and be able to achieve renewal and that any anticipated outlays to be incurred as part of achieving the renewal are nominal. Such evidence should consider the required consent of a third party and the satisfaction of any conditions required to achieve renewal.
  - An indefinite life (no amortization) is permitted so long as there are:
    - No limiting legal, contractual, regulatory, technological, or other factors, and
    - No subsequent change in circumstances.
    - A permanent right-of-way easement is an example.

*Retroactive Application.* For GASB 34 Phase I & II governments, retroactive reporting is required for intangible assets acquired in fiscal years ending after June 30, 1980. Retroactive reporting is not required for intangible assets with indefinite useful lives or internally generated intangibles, as of the effective date of this Statement.

#### *Current Status:*

The City will work with our auditors to assure timely and accurate implementation as each phase becomes effective.

## CITY OF NAPA

### MEMORANDUM ON INTERNAL CONTROL CURRENT STATUS OF PRIOR YEAR OTHER MATTERS

#### **2007 -05: Financial System Improvements**

Staff has begun the process of implementing a new financial system including starting to design the chart of accounts and other initial processes. In that regards, we have a few suggestions to consider in the implementation of that new system which are listed below:

*Update the Chart of Accounts:* A thorough update of the chart of accounts is an important step in maximizing the effectiveness of the new system. The City's complex operations and the unique HUD requirements imposed on the Housing Authority make this step especially crucial for the City.

For instance, the Housing Authority is required to use an online system for financial reporting to HUD. The City should consider structuring the Housing Authority Chart of Accounts to conform to the Financial Data System (FDS) of HUD.

Also there are certain data contained in the annual reports of financial transactions for the City, Redevelopment Agency and the Street Report which will be needed. These reports and their impact on the Chart of Accounts should also be considered.

*Automation of Journal Entries:* We are aware that the City has employees manually prepare journal entries, with other employees reviewing and approving these entries to ensure they have been properly prepared and are correct. We understand that a third employee then enters the journal entries into the System. As part of our work we look for ways to improve procedures and simplify them while at the same time strengthening controls. We believe automating the journal entry process is an example of such improvements. We have other clients which have automated the journal entry process. Under these other systems, the originating employees prepare the entry on-line. Another employee reviews the journal entry on-line and once they approve the entry, the system automatically posts the entry to the general ledger. If the City were to adopt this approach, it would eliminate one employee's efforts from the process and reduce time shuffling paper from desk to desk.

*Duplicate Invoice Numbers:* The accounting software that is currently used by the City cannot search the system by invoice number so it might not prevent paying duplicate invoices. A good system control would be a pop-up type warning telling the user that the same invoice has already been paid and if the user is sure they would like to pay it again. As it stands now, one invoice can be paid an infinite amount of times. The City should upgrade their accounting system to stop this event from occurring.

*Accounting System Access Log:* The City was not able to produce the security access log for our review. It came to our attention that no one reviews the access log. The City should perform a review at least on an annual basis.

*Payroll System Reports:* The system report providing the salary rates based on employee range and type is not easily readable. The system needs to be equipped to provide well defined and structured information for the users.

*Current Status:* System implementation was in process as of June 30, 2009.

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## **CITY OF NAPA**

### **REQUIRED COMMUNICATIONS**

March 15, 2010

To the City Council of the  
City of Napa, California

We have audited the financial statements of the City of Napa as of and for the year ended June 30, 2009 and have issued our report thereon dated March 15, 2010. Professional standards require that we advise you of the following matters relating to our audit.

**Financial Statement Audit Assurance:** Our responsibility, as prescribed by professional standards, is to plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit in accordance with generally accepted auditing standards does not provide absolute assurance about, or guarantee the accuracy of, the financial statements. Because of the concept of reasonable assurance and because we did not perform a detailed examination of all transactions, there is an inherent risk that material errors, fraud, or illegal acts may exist and not be detected by us.

**Other Information Included with the Audited Financial Statements:** Pursuant to professional standards, our responsibility as auditors for other information in documents containing the City's audited financial statements does not extend beyond the financial information identified in the audit report, and we are not required to perform any procedures to corroborate such other information. Our responsibility also includes communicating to you any information that we believe is a material misstatement of fact. Nothing came to our attention that caused us to believe that such information, or its manner of presentation, is materially inconsistent with the information, or manner of its presentation, appearing in the financial statements. This other information and the extent of our procedures is explained in our audit report.

## CITY OF NAPA

### REQUIRED COMMUNICATIONS

**Accounting Policies:** Management has the responsibility to select and use appropriate accounting policies. A summary of the significant accounting policies adopted by the City is included in Note 1 to the financial statements. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2009. As described in notes to the financial statements, during the year, the City implemented the following new standards:

- Statement No. 49 - Accounting and Financial Reporting for Pollution Remediation Obligations

This Statement establishes financial reporting of obligations for pollution remediation. Additional disclosures were required as a result of this statement which are presented in Note 16.

**Unusual Transactions, Controversial or Emerging Areas:** No matters have come to our attention that would require us, under professional standards, to inform you about (1) the methods used to account for significant unusual transactions and (2) the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. There have been no initial selections of accounting policies and no changes in significant accounting policies or their application during 2009, other than the following new statement discussed above.

**Estimates:** Accounting estimates are an integral part of the financial statements prepared by management and are based on management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The most sensitive accounting estimates affecting the financial statements are discussed below:

- *Estimated Fair Value of Investments* (Note 3 to the financial statements) - As of June 30, 2009, the City held approximately \$139 million of cash and investments as measured by fair value. Fair value is essentially market pricing in effect as of June 30, 2009. These fair values are not required to be adjusted for changes in general market conditions occurring subsequent to June 30, 2009.
- *Allowance for Doubtful Account – Notes Receivable* (Note 5 to the financial statements): The City has loaned approximately \$21 million to other parties to promote its low and moderate income housing programs. As of June 30, 2009, management had established an allowance for collectability of approximately \$7 million based on its estimate of the ultimate likelihood of collection.

**Disagreements with Management:** For purposes of this letter, professional standards define a disagreement with management as a matter, whether or not resolved to our satisfaction, concerning a financial accounting, reporting, or auditing matter that could be significant to the City's financial statements or the auditor's report. No such disagreements arose during the course of the audit.

Management informed us that, and to our knowledge, there were no consultations with other accountants regarding auditing and accounting matters.

**Retention Issues:** We did not discuss any major issues with management regarding the application of accounting principles and auditing standards that resulted in a condition to our retention as the City's auditors.

**CITY OF NAPA**  
**REQUIRED COMMUNICATIONS**

**Difficulties:** We encountered no serious difficulties in dealing with management relating to the performance of the audit. However, the completion of our work was delayed several times due to the system implementation issues discussed in our comment **2009-01 -Timeliness of the Close of the Books.**

**Audit Adjustments:** For purposes of this communication, professional standards define an audit adjustment, whether or not recorded by the City, as a proposed correction of the financial statements that, in our judgment, may not have been detected except through the audit procedures performed. These adjustments may include those proposed by us but not recorded by the City that could potentially cause future financial statements to be materially misstated, even though we have concluded that the adjustments are not material to the current financial statements.

We did not propose any audit adjustments that, in our judgment, could have a significant effect, either individually or in the aggregate, on the entity's financial reporting process.

**Uncorrected Misstatements:** Professional standards require us to accumulate all known and likely misstatements identified during the audit, other than those that are trivial, and communicate them to the appropriate level of management. We have no such misstatements to report to the audit committee.

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This report is intended solely for the information and use of the City Council, its committees, and management and is not intended to be and should not be used by anyone other than these specified parties.

*Mage Associates*

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